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Economic Affairs
Student & Teacher Supplement

Note from the Editor

The *Economic Affairs'* 'Student & Teacher Supplement' brings together short articles from IEA authors for undergraduate students, teachers, sixth formers and others. The first edition has two perspectives on the future of economics as a discipline – this is something that is especially important given the way in which current approaches to economics have come under attack since the financial market crash of 2008. It also contains an article on the measurement of poverty – an important area of applied economics where bad practice leads to bad policy.

We hope that this new publication will be read widely and are very happy for teachers to photocopy it for their students. It will also be available electronically.

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Prof. Philip Booth
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The Future of Economics is Rational By Andrew Lilico

The most fundamental idea in economics is that no behaviour is irrational – you have not explained someone's behaviour until you have explained why it made sense to *her* to behave in that way.

There are alternative approaches. If you ask a physicist why my arm went up in the air he may tell you something about masses and forces. If you ask a biologist why it happened, he might tell you about hormones and nerve impulses. These ways of looking at the problem, in which we make no attempt to show why I thought it made sense to raise my arm but explain it in some other way, have their place and value. But they aren't economics.

The credit crunch has presented us with a number of situations in which it isn't obvious why it made sense for people or corporations to act as they did. Many have responded to this by suggesting that economics needs to dispense with the assumption that people behave rationally. But just because it's tricky to offer a rational explanation of behaviour doesn't mean we shouldn't try, and doesn't mean that trying won't be fruitful.

Some people imagine that saying that behaviour is 'irrational' is an explanation. But saying that behaviour is 'irrational' does not explain anything in particular, because it too cheaply explains everything. Let us illustrate why with an example.

Normally, as the price of goods rises demand falls. But there is a special class of goods (Giffen goods) for which, as the price rises. the amount demanded actually rises. Classic nineteenth-century examples given include potatoes in Ireland and bread in certain European cities.

Economists explain these cases by distinguishing between two effects of price rises: 'substitution effects' (as people switch between buying that good and buying other, now relatively cheaper goods), and 'income effects', as people change their consumption because they become poorer when prices rise. Sometimes, when people become poorer, they focus more of their spending on necessary basic foods. In an extreme case this 'income' effect can outweigh the switching effect, so that when the prices of potatoes or bread rise, demand for them can actually rise.

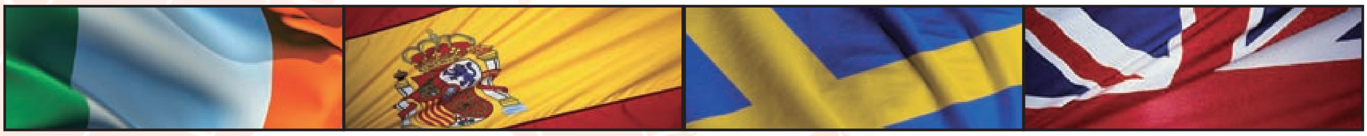
This income versus switching effects distinction is the foundation of modern consumer theory. But fans of irrationality would surely have said: 'Well, if people were rational then when the price of things rose they'd buy less. But behaviour is not always rational, as can be demonstrated by the examples of bread and potatoes.' By not struggling with the difficult mystery of how to make sense of what was going on, they would have missed out on the key insight.

Standard economic theory never pretended, contrary to billing, that it could predict perfectly what would happen in the world. But it does offer us a method by which to make sense of things and to learn lessons that we might apply, fruitfully, in the future. That's the way forward. We should not try to make sense of the financial crisis by throwing the economists' key tools away but by trying to understand the subtle effects of regulation, monetary policy and incentives within firms that made banks behave as they did. Young economists shouldn't be seduced by those who suggest that the financial crash has made a mockery of 100 years of economic thinking.

Andrew Lilico, Chief Economist at Policy Exchange

Of Poverty and Poverties

By Kristian Niemietz



In 2005, a study by UNICEF's Innocenti Research Center argued that since the mid-1990s, child poverty had increased significantly in most OECD countries. To a British reader, such findings will sound familiar. 'End Child Poverty', a charity umbrella organisation, has been reporting for a while that '4 million children – one in three – are currently living in poverty in the UK [...] This is a shocking figure given the wealth of our nation'. A decade ago, the government pledged to eradicate child poverty and has nearly doubled spending on child-contingent benefits and childcare since then.

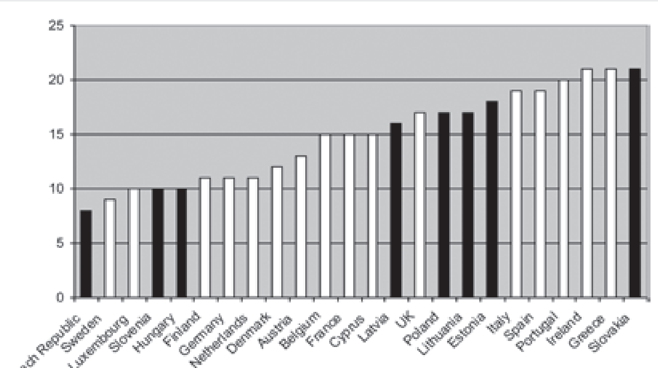
Nevertheless, several findings of the UNICEF study will appear surprising to the casual reader. It reports that the prevalence of child poverty is higher in Luxembourg than in Hungary, higher in Japan than in Poland, and no lower in Switzerland than in the Czech Republic. UNICEF does explain that these results alone do not give a complete picture. But this cautioning does not seem to affect the conclusions they draw from the results.

Poverty rightfully receives a lot of public attention, but unfortunately there is no clear-cut consensus on what actually constitutes poverty. UNICEF follows the convention of most affluent countries to define poverty in *relative* terms; that is, relative to a living standard that is considered 'typical' for a particular place at a particular time. The 'typical living standard' is usually represented by the median income, the income earned by the person at the midpoint of the distribution (half earn more, half earn less). People are classified to be in relative poverty (or 'at risk of poverty') if their income falls below a threshold of usually 50%, or 60%, of the median income in their country of residence.[1] A ranking of EU countries by their prevalence of relative poverty looks as shown in Figure 1.

On this measure, poverty is no higher in the much less affluent nations of Central and Eastern Europe (the bars marked in black) than in the West. This is because a relative indicator does not tell us anything about the quantity and quality of goods and services that the people at the bottom of the income distribution can afford. It shows us, instead, how well-off people at the bottom of the income distribution are *compared with people in the middle* of the income distribution in their country. In an extreme example, this means that in a society of billionaires, a millionaire would be relatively poor, because he/she has much less than what is typical in this society. On the other hand, in a transition country, a family that could not afford a damp-free home would not be in relative poverty, as long as the middle classes could not afford a much better standard either.

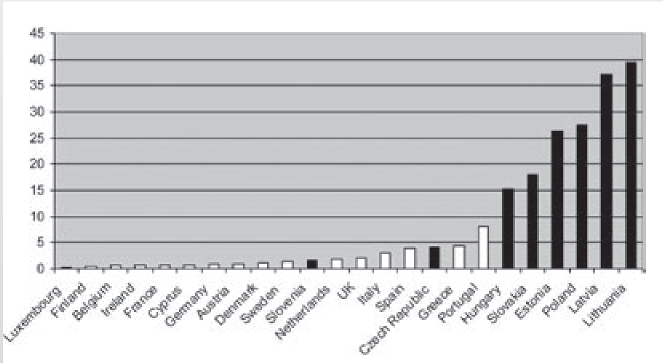
In societies with higher average levels of prosperity, social norms and expectations are more demanding. A living standard that is considered adequate by most inhabitants of a poor country could be perceived as insufficient by most inhabitants of a prosperous country. There is not much point in using an indicator that is out of line with people's actual perceptions. But is it plausible to assume that social norms and expectations are uniform within a country, and stop abruptly at the border? If not, a case could be made, for example, for adopting a common poverty line for an increasingly integrated Europe. A ranking of EU countries by their prevalence of poverty, as measured against a common poverty line (the local equivalent of €10 a day[2]), looks as shown in Figure 2.

Figure 1: Relative poverty in the EU (poverty line = 60% of national median income)



Source: Eurostat (2005).

Figure 2: Absolute poverty in the EU (poverty line = local equivalent of €10 a day)



Source: Eurostat and European Commission (2008).

There is now suddenly a very strong regional divide, with poverty being much more prevalent in Central and Eastern European nations. Poverty now appears strongly linked to a nation's overall level of economic development, emphasising the role of growth and wealth creation, as opposed to redistributing what is already there.

Measures like this are referred to as 'absolute' poverty indices. 'Absolute' does not mean 'more severe', but less dependent on the incomes of other people. If an individual moves to a much richer or poorer nation, and takes their income with them (disregarding differences in price levels), their absolute poverty status does not change, but their relative poverty status might very well.

The same logic applies to the question of how the poverty line should change over time *within* a given territory. Relative poverty lines are 'moving' poverty lines; they change whenever the average income changes. Table 1 shows the evolution of poverty in Ireland, Spain, Sweden and the USA in the second half of the 1990s, when using moving poverty lines.

A poverty indicator ought to reflect that views and attitudes about poverty change dramatically over time. A successful merchant in the seventeenth century may have been considered wealthy by his contemporaries, but by our modern standards, he would be desperately poor: he had no access to electricity, central heating or pain-free dental care. But do these perceptions change so rapidly that the poverty line needs to be updated each single year? In particlar, should the poverty line change rapidly when median incomes grow rapidly for a number of years, as happened in the four countries listed in Table 1? Absolute poverty thresholds, in contrast, remain constant at least over a number of years. They only change in line with the price level and not average earnings. The picture for the same four countries would then look like Table 2.

The first measure would suggest that during the period of fast growth, few people have actually been lifted out of poverty, and in fact more may have been plunged into it. The second measure suggests that fast growth *has* enabled a lot of people to climb out of poverty; or at least that the ranks of the poor have not notably grown.

But whichever way we set the poverty line – as long as we use 'income' when what we actually mean is 'living standards' – we will be left with a very incomplete picture anyway. 'Income' is only what we receive in a particular year, regardless of what we already have. If David Beckham decided to take a year off, he would appear in the poverty statistics, because in that year his income would be zero.[3] In contrast, if Beckham managed to gamble away all his wealth and even to amass a skyrocketing pile of debt, he would be no closer to the poverty line. His income, after all, would be unchanged. This points towards the logic of consumption-based measures of poverty – a subject that will be explored on another occasion.

Table 1: Changes in relative poverty in four affluent nations, 1996–2000

	Relative poverty 1996	Relative poverty 2000	Percentage point change
Ireland	19.1%	21.4%	+2.3
Spain	20.3%	18.8%	–1.5
Sweden	8.9%	10.4%	+1.5
USA	21.7%	23.5%	+1.8

Source: Notten and de Neubourg (2007).

Table 2: Changes in absolute poverty in four affluent nations, 1996–2000

	Absolute poverty 1996	Absolute poverty 2000	Percentage point change
Ireland	20.1%	10.6%	–9.5
Spain	29.8%	19.1%	–10.7
Sweden	7.1%	5.7%	–1.4
USA	8.5%	8.7%	+0.2

Source: Notten and de Neubourg (2007).

1. Account is taken of the fact that people live in households of different sizes, which means that their incomes are not comparable at face value but have to be made comparable first. People in a three-person household, for example, do not need treble the money of a single household to achieve the same standard of living. They can share many things, such as their flat, car, washing machine and TV. This is adjusted through a process called 'equivalisation', which attaches a different weight to each household member.
2. Benefits in kind, such as free or subsidised social housing, healthcare and transport, are usually not counted as income. Nobody could, of course, pay rent, health insurance and transport in any Western city on a budget anywhere near €10 a day.
3. This ignores, of course, his capital income, which would probably be sufficient to make him a top earner.

References and further reading

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Kristian Niemietz, IEA Poverty Fellow

The Future of Economics is 'Austrian'

By Mark Pennington

If one were to offer a reason why the future of economics should be 'Austrian', it would be hard to better the following statement by Hayek: 'Data from which the economic calculus starts are never for the whole society given to a single mind which could work out all the implications and can never be so given'. (Hayek, 1948, p. 77).

The central task of economic theory is to examine the institutions that enable individuals and organisations to co-ordinate their actions. Instead of assuming that people already 'know what to do', economists should focus on which institutions enable actors who *lack* knowledge to *learn* from one another's successes and failures.

One of Hayek's most profound insights was that competition should be seen as an evolutionary discovery process. Different people know different things and even when confronted with the same information may interpret that information differently. Central planners in government cannot accumulate the necessary information about costs and benefits of different actions because that information is naturally dispersed. A competitive, decentralised market economy, on the other hand, allows different ideas about how to use economic resources to be tested against one another. One person might try to run a mini-bus service to the local nightclub, and another run a personalised taxi service. Both may fail, both may be successful or one may fail and the other be successful, but it is the signal of profit and loss that enables us to find out which uses of economic resources best meet people's needs in the most efficient way. There will be trial and error and learning as participants imitate the successful and learn not to make the same errors as the unsuccessful.

The perfect competition model of the A-level textbook is an illusion. It can never be achieved because competition is a continual process of entrepreneurs discovering which business models to follow and which to avoid. Central planning and government regulation are the worst form of decision-making to adopt. They reduce the range of experiments that may be conducted to those conceived by the planners and regulators and by centralising control over resources increase the possibility of systemic failure should these actors be mistaken in their judgments.

The basic assumptions of mainstream neoclassical economics assume away what has to be explained. This is true both of those theorists who support the 'free-market' economy (the Chicago School) and of those who arrive at more interventionist conclusions (for example, Stiglitz and his followers). In the former instance, assumptions of perfect information and perfect competition lead to the view that markets produce optimal results. In the latter, while recognising that real-world markets fail to reach equilibrium owing to imperfect information, no explanation is given of how regulators can bring about the necessary equilibrium in the place of markets – it is simply assumed that they can.

One could not have a clearer illustration of the superiority of the Austrian approach to economics than the current financial crisis. The neoclassical model finds it hard to explain how such a crisis could come about. If market actors are perfectly informed or behave 'as if they are', then how could a systemic failure of the market economy ever occur? If, on the other hand, regulators are as omniscient as the interventionist approach implies, then why did these same regulators fail to see the crisis coming? The Austrian perspective, by contrast, directs attention to those elements of the current monetary and financial architecture that might have increased the possibility of 'systemic failure'. It suggests that operation of monetary policy through state-controlled central banks increases the possibility of major errors in policy reverberating through the economic system. Similarly, recent problems highlight the tendency of an overly centralised system of financial regulation to encourage financial institutions to make the same mistakes, and point towards competition between *different* systems of regulation as the best protection against 'systemic failure', rather than the frequent obsession of today's policy-makers with ever greater European and international 'harmonisation'.

Reference

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